DOW THEORY LETTERS INC.

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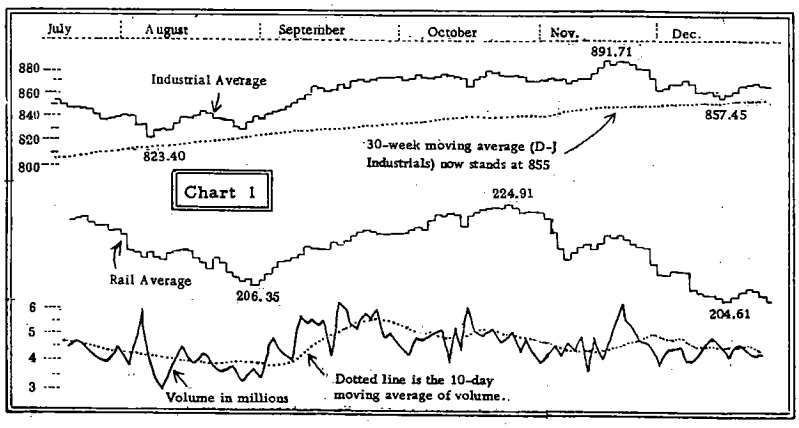
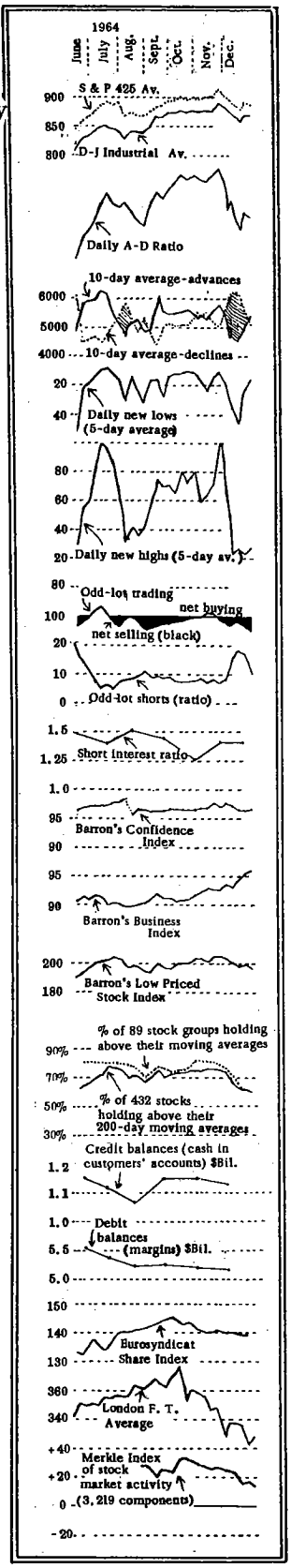
THE MARKET: The Rail Average recorded its high in late October (see Chart 1). Following a decline, the Averages again rallied with Industrials touching an all-time high in mid-November. Rails, however, failed by a wide margin to confirm the November Industrial peak. Subsequently a new decline took the Averages to mid-December lows. For Dow Theorists the flagrant November Rail non-confirmation clearly indicated a fizzling of the upside momentum. The big question remains — has the market merely retreated to the "safety" of lower levels, or are we seeing the beginning of major trouble for Wall Street?

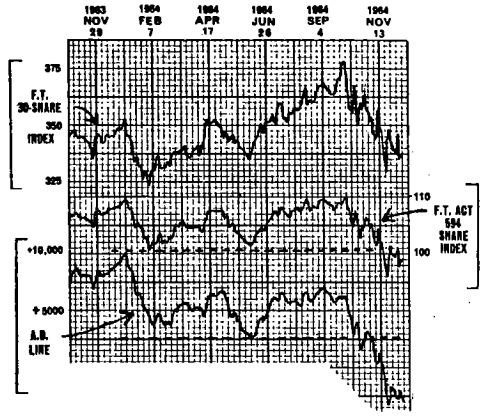
Currently, we are in one of those happy areas (happy for Dow Theorists) in which the two Averages have established important nearby checkpoints. As seen on Chart 1, highs were recorded by Industrials and Rails at 891.71 and 224.91 respectively during October-November. The decline to December 15 took the Industrial Average to a low of 857.45, Rails to 204.61. On December 24 the Rail Average sank to a new low of 204.48 accompanied by the usual light pre-holiday volume. In the 67 year history of the Averages, important weakness has never shown itself between Christmas and New Year, so we can look to 1965 for the next potentially significant market action.

As to 1965, there is little point in attempting to "outguess" the market when with so little movement the market itself can provide us with the real answer. A hurdling of the 1964 highs by both Averages would obviously reconfirm the bull trend and point to better things ahead (particularly if the upward penetrations were accompanied by expanding volume). Conversely, a penetration of the December low by Industrials (Rails are already in an established downtrend) would have ominous implications for the market (the more so if volume expanded on the downside). Because the 30-week moving average for Industrials is now (perhaps coincidentally) within 2 points of the December low (see Chart 1), the significance of the 855-857 level for Industrials is heightened. If Industrials break below the 855 level with Rails following in direction, this writer would exercise the utmost caution (and would be willing to hold few if any common shares — with the exception of gold and silver).

The Composite Chart shows the DJI and the S & P 425 sinking back within their range of the past 4 months (6 months in the case of S & P). At the same time, the A-D ratio has wiped out all its gains since the August low. The 10-day averages of the advances and declines, after a good deal of selling pressure (shaded area), are back in equilibrium, and this is confirmed by new lows which have receded sharply (although new highs have definitely not expanded). Odd-lotters normally increase (tax) selling during late-December, so that here we see the normal phenomenon. The short interest ratio held practically unchanged at 1.42 for December, and this indicator is still rated neutral-bullish. While Barron's Business Index touched a high this week, Barron's low priced Stock Index appears to have established a a double top (July-November) and turned down. L-P stocks usually turn down before the DJ Industrials, and we may be seeing just such a sequence now. The percentage of 432 stocks holding above their moving averages dropped to 60% this week, lowest level since May. The critical level on this study is 50%, so any further weakness could be very important for this indicator. Credit and debit balances for December were each down $24 million, showing that the public bought stock and spent cash (negative) while the professional continued to reduce his margin account (also negative). Finally, I include an extra chart which shows the British market story in great detail (chart courtesy of The Investor, 50 Denmark Hill, London S.E. 5). Note that (as with our market) the broader the measure, the worse the picture. Thus, the







Financial Times 30 Share Index (comparable to our Dow) has broken badly but is still above its February low. But the broad F. T. 594 Share Index (comparable to our S & P 500) has broken below all 1964 lows. The A-D ratio in Britain never confirmed the second-half highs in the other two indices, and it lead the collapse which started in September.

Conclusion: the indicators are becoming critical, and if their profiles continue deteriorating at the present rate, I would expect important weakness early next year.

TWO FRIENDS meet. Each is a knowledgeable market student. Only one thing sets them apart. Mr. A is bullish, and Mr. B is bearish. I "happened" to overhear these two gentlemen yesterday, and, in fact, I took the liberty of copying down a bit of their conversation. Mr. A (the bull): "Let's stick to classic Dow Theory. The market's considered to remain bullish until proved otherwise. So far, we haven't received a bit of bearish proof. The Averages touched highs of 891.71 and 224.91 last October and November. And all the while, they've been trying to scare us to death with news. We had a threatened rail strike, a strike at GM, the Chinese set off their atom bomb, Khruschev got his walking papers, Viet Nam turned from bad to ridiculous, the Congo blew up, Britain went into its worst sterling crisis since World War II and interest rates went up here and abroad. And what are the results? The Industrial Average went off a mere 5% to 857.45 (December 15) and Rails sagged 9% to 204.61. Why, the retreat doesn't even qualify as a secondary reaction.

"Meanwhile, the latest (December) short interest figures (just under the all-time record of 7 million shares sold short) shows you that almost everyone and his brother is bearish. And the steady off-lot selling suggests the same thing. When the bears have sold out and sold short and the market still holds, it's a bullish situation. Furthermore, when a market holds the way this one does in the face of an avalanche of bad news — it means that it wants to go higher. Time is on the side of the bulls, my friend. Put away your crying towel, wipe off the bear grease, and get ready. The next major move for this market is up."

Mr. B (the bear) speaks. "I've been trying to be bullish; really I have, but I've been bothered by one thing — the facts. I hate to bring all this up at a time when everyone is supposed to be shouting "Happy New Year," but let's look at a few of those facts. We're now only 5% (D-J Industrials) above the first quarter, 1964, peak — and this in the face of the fanciest earnings and production records in years. Cyclical groups like steels, rails, papers, cements and aluminums look terrible. The majority of stocks, as measured by the advance-decline ratio, have done nothing throughout 1964. The last time the A-D ratio acted this way in the face of a series of new Industrial highs was in 1961 — and I don't have to tell you what happened in 1962. The poor performance of most stocks is also being reflected in the pitiful list of daily new highs.

"Furthermore, major trouble has appeared and is continuing in the area which is least familiar to most Americans — the money area. But the British market knows what's happening. England is now in a major bear market, and as soon as the U.S. sees the implications of this (dumping of goods, shrinking British markets, stiff competition, higher money rates) we're going to join them. Don't get me wrong, Mr. A, I'm no professional pessimist. I simply make a living by facing facts. If the D-J Industrials and Rails rise to new highs (above 891.71 and 224.91) I'll be the first to admit that I'm tuned in on the wrong wave length. But in the meantime, it looks like a long, hard winter. And as a final observation, I'll add that I've never seen the Rail Average act more sluggish. If our locomotives acted as "tired" as the Rail Average, they'd be feeding them with Geritol instead of diesel oil."

The two friends then parted company and made directly to the nearest phone booths. They evidently convinced each other of nothing, for I heard Mr. A call his broker and purchase another 100 shares of GM. Mr. B (bear that he was) called his banker and told him to "roll over" his Treasury bills again.

LEADING ANALYSTS (continued): The last analyst in the series (but hardly the least) will be economist Eliot Janeway. What other analysts do with charts, Janeway does with sheer economic acumen and a prodigious mass of information. With a background as business editor of Time Magazine, member of the board of directors of many corporations, syndicated newspaper columnist and editor of the Janeway Service and the Janeway Letter, this gentleman has access to facts and information which most economists never hear about. Janeway has a vast political knowledge and his advice is listened to by everyone from graduates at the Harvard Business School to President Johnson himself.

Janeway was correctly bullish throughtout the 1950's, but as the '60's were ushered in he became progressively pessimistic. Janeway was frankly dubious regarding President Kennedy's handling of the business situation, and he was one of the first to detect and predict the former President's altercations with businessmen.

When President Johnson came to the Presidency, Janeway announced that he believed (despite the tragedy of the circumstances) that it was "a new ball game." So far, events, at least on the surface, have proven Janeway to be correct again.

Janeway believes that politics constitutes one of the strongest forces on the market. To be ignorant of politics and government "thinking", he believes, is to be oblivious of many of the most powerful forces in Wall Street. One of Janeway's talents lies in being able to get behind the men and the events, and in spotting trends weeks and months before they become apparent to other leading economic services.

As an example of Janeway's "advance notice" writing, he stated in a late mailing that the next danger to the U.S. may lie in a possible European deflation with accompanying "dumping" of European goods on the U.S. markets. In the same letter (at which time everybody seemed near-hysterical about the "multi-lateral nuclear force"), Janeway (correctly) dismissed the MLF as so much "mumbo-jumbo." The MLF, he wrote, "was made to order as a cover for the money crisis ..... The purpose the MLF story served, while Wilson was in Washington, was to get the sterling crisis out of sight — as the necessary step in buying time and repairing the damage." This is the kind of information, often shocking, often cynical, which Janeway readers pay for. The reason — it is so often the right information.

What does Janeway think now? Janeway is guardedly hopeful about 1965. But he did not care for the Federal Reserve Board's recent boost in the discount rate. He believes the rise was meaningless, and that it was merely the Board's way of showing its independence of the Executive branch. Any further action of this type, says Janeway, could bring on trouble. Recently (in Boston) Janeway told a group of businessmen: "The impact of the money muddle and of its politican camp-followers upon the stock market is now making itself felt..... A full-scale break is still highly unlikely, but the money muddle has clamped a ceiling on the market, and it will not be removed until the issue is settled and the muddle is made clear."

SUNDRY COMMENTS: Over the past week or so I have been besieged by questions regarding gold stocks and monetary problems. The section in Letter 274 concerning DeGaulle and France seems to have struck many people as "a shocker." To amplify that section, subscribers should understand that France is now mounting a subtle but definite attack on the dollar and the pound as reserve currencies. "What about multi-lateral devaluation?" I am asked. My answer is that I do not think DeGaulle (as leader of Europe) wants it or would stand for it. If we could tune in on DeGaulle's secret thoughts, this is what we might hear: "Look at the great Anglo-Saxon nations. Already, Britain is a shaky third rate power, its industry unable to compete, its currency being actively sold short by frightened businessmen and speculators who are hedging against devaluation. Look at the U. S. It has been reveling in a speculative boom which has undermined its credit and eroded its gold position to its lowest state in modern history. A pound devaluation is imminent, and a devaluation of the pound could also topple the dollar. Thus these two once great reserve currencies are becoming less and less attractive as vehicles to settle international accounts." DeGaulle might smile as he adds: "It would pay the world to give increasing attention to the franc as a reserve currency. For here we offer you a gold-backed currency and one of the hardest currencies in the world."

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Meanwhile, the Russian bear knows where his bread is buttered. One of the things Khruschev was criticized for was using up too much of the Soviet's gold reserves. Recently the Russians have been shopping in West Germany for gold mining machinery. Russia wants to step up her gold production. Russian gold sales to the West were averaging about $200 million per year, but they jumped to $400 million in 1963 and will do the same in 1964. Hamburg shipyards have been asked to bid on huge gold dredges for Russia, dredges capable of processing 10,000 cubic yards of material per day. Obviously, Russia (which now produces about $400 million worth of gold per year) is extremely anxious to increase her output. She seems to have few doubts about the value of the yellow metal, and even fewer doubts that the world will go off the gold standard in the years ahead.

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The problem Britain faces is this: Britain has (unofficially) promised the U. S. that she will not devalue. But if this is true, then Britain must deflate now. Her bank rate has been boosted to 7%, and already there are reports of sharp declines in consumer and capital spending in Britain. A British recession appears to be on the way.

Latest polls show the Labor Party's popularity falling rapidly. Will Britain be able to keep her promise not to devalue? Or will politics rule, and will Britain take the easier way out? If Britain does devalue, what will (or can) the U. S. do? Will we defend the dollar with high interest rates, austerity, a squeeze on prices and labor costs? At a seminar in New York, famed monetary expert Franz Pick predicted another crisis for the pound within (approximately) 90 days, a devaluation of the pound and a subsequent dollar devaluation. "How can we avoid dollar devaluation?" Pick was asked. His answer: a rise in the U. S. re-discount rate to 7½%, and a rise in the prime rate to 9% — in other words, forced deflation.

Meanwhile from Chicago leading money expert Melchior Palyi writes: "Reluctantly, the Labor government is beginning to take steps in order to step up the domestic flow of credit. It has no alternative. In any case, the much advertised 'first 100 days' that were to remold Britain on the Socialist pattern, may terminate in the sharpest deflation the United Kingdom has suffered since 1931 — devaluation or no devaluation.

Thus, those who believe that the U. S. will defend the dollar are correct in selling stocks while holding cash and short-term Treasury bills. For if we defend the dollar, interest rates are sure to sky-rocket to levels not seen in a generation. On the other hand, if we refuse to deflate, if we buy time by continuing to feed money to Britain so that she can support the pound, then progressive monetary degeneration and final devaluation seems assured. The latter course favors the golds. Which course will the U. S. and Britain take? Devaluation rather than deflation would appear to be the likelier, but no one knows for certain.

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The following (postmarked December 16) is from my friend Harry Schultz now in England: "The true state of Great Britain's troubles are not being revealed which is standard policy until the dust settles, but my inside sources tell me it is awful. Devaluation of the pound is apparently an absolute certainty. Only a matter of how soon. Money is not coming back to Britain despite the 7% rate. Big money smells big trouble."

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In this writer's opinion, we are in the midst of some sort of "manipulation climax." While the U. S. supports many commodities, it is also supporting its bond market through open market purchases. Japan is supporting its stock market via syndicate purchases. Britain is supporting its pound against speculators, and it is now announced that Britain is supporting her entire Government bond market which has been slumping

through fears of still higher interest rates. Thus the manipulators are sinking nearer and nearer to an obviously untenable position, a position which can only end with "a bursting of the financial dam." William Hamilton, the famous Dow Theorist, was aware of the impossibility of massive manipulation of natural forces. He once said that neither the Federal Reserve nor the Bank of England possessed enough money to manipulate the Dow Jones Averages. But manipulating the Dow is a "drop in the bucket" compared to what "money managers" around the world are attempting today.

STOCKS: Chartcraft of Larchmont, N. Y. classifies all S & P groups in terms of momentum (based on relative strength of each group against the S & P 500 — plotted on a 17 week cycle). The top five groups are now (1) Gold Mining, (2) Radio TV Broadcasters, (3) Metal Fabricating, (4) Constr. Machinery, (5) Promotional Dept. Stores. Bottom five are (86) Steels, (87) Sugar Cane Producers, (88) Machine Tools, (89) Cements, (90) Cigar Mfg.

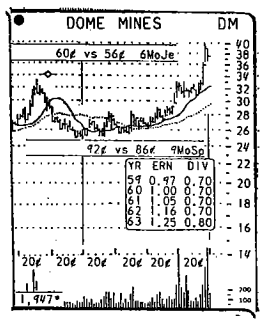
This is the first time in 1964 that Golds have made the number 1 spot. The accompanying gold chart was last shown in Letter 270. Note the massive breakout in the Gold Stock Average to its all-time high. Note also the confirming breakout in the relative strength (RS) of this group.

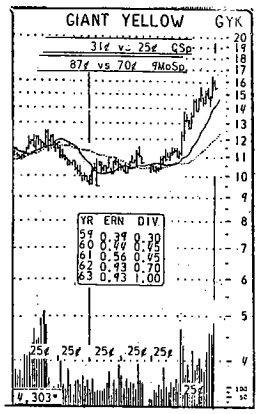
In Letter 263 I discussed what I call my "30% rule," and this is now restating in view of the huge moves in the individual (Canadian) gold issues. In Letter 263 I wrote that the 200-day moving average (MA) can be an excellent guide for measuring "over-enthusiasm" or "over-pessimism" in individual stocks. Whenever buying or selling carries a stock approximately 30% or more above its MA, the odds are strong that the stock is overdue for a correction — a correction which may take the stock back to the vicinity of its MA again.

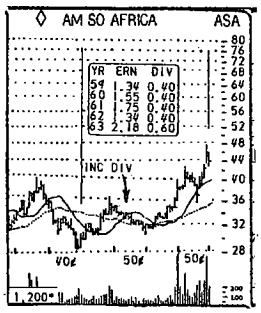
Because of recent broad market weakness, few common shares are now subject to the 30% rule. The following shares, in fact, are the only ones on the N.Y.S.E. which are now suffering from "over-optimism" as judged by the 30% rule: Chicago Gt. West. RR, Congoleum-Nairn, City Stores, United Aircraft.

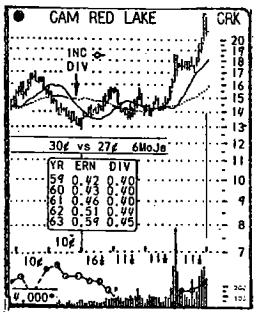
However, note that the 30% rule can now also be applied to the leading Canadian golds and to Amer. S. African Investment Trust. If a stock is extremely strong, it may hold or consolidate while its MA rises to meet it (in lieu of a major correction). This may or may not occur in the golds (I rather think it will). Many subscribers with 25 to 40% profits in their golds are writing to ask whether they should take their profits. I simply do not know. But if this is a primary move in golds (and I believe it is), then the best procedure is to hold your golds and let events unfold. Primary movements have a way of going further than anyone believes possible. I have no idea whether history is going to repeat again, but I offer a chart of Homestake Mining (1924-35) to show what occurred last time devaluation struck. Britain devalued in 1931; HM rose from about 80 in January, 1931, to about 150 by the end of 1931. Then as it became more obvious that the U.S. was going to devalue (which occurred in 1933), the real move got underway. Note HM's earnings following devaluation (bottom of chart).

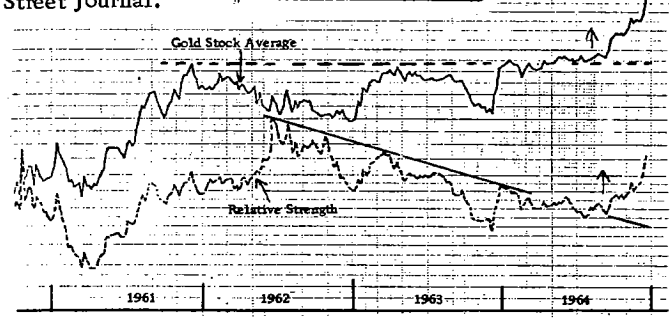
Recommendation: If you have not bought Canadian golds, you should probably wait on these (in the hopes of a correction). The same applies to Amer. S. African (recommended here originally at 33). What to do next: The S. African gold index ("Kaffirs") today touched a high for the year at 69.1. But S. African golds may still be bought on the basis of "values." My choices: Blyvoors now around 4 with a 43¢ dividend to yield 10%; Free State Geduld now at 20 with a $1.33 dividend to yield 6.5%; Presidend Brand at 11 with an 88¢ dividend to yield around 7%; Western Holdings at around 30 with a $1.75 dividend to yield 5.8%. All are listed under the "Foreign Securities" section of the Wall Street Journal.











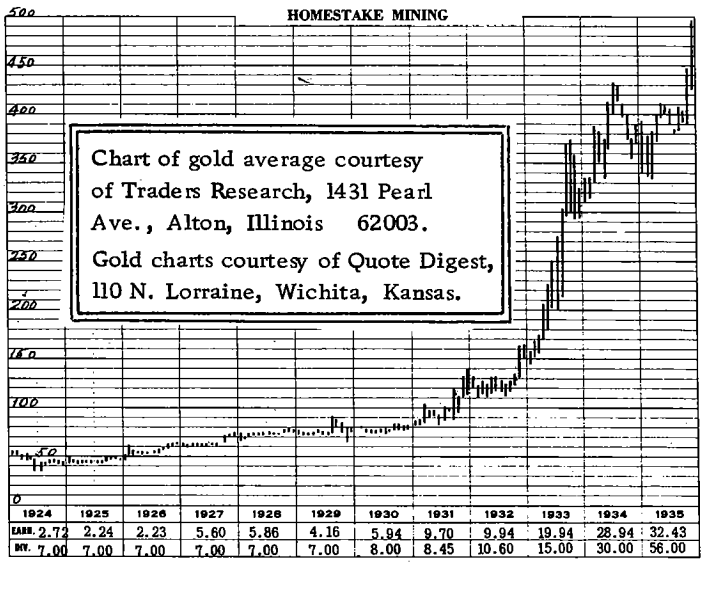


Chart of gold average courtesy of Traders Research, 1431 Pearl Ave., Alton, Illinois 62003.
Gold charts courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas.